

Internal Revenue Service
Office of Federal, State and Local Governments

<http://www.irs.gov/govt/fslg>

FSLG Newsletter – January 2014

This is the semiannual newsletter of the office of Federal, State and Local Governments (FSLG) of the Internal Revenue Service. Our mission is to ensure compliance by Federal, state, and local governmental entities with Federal employment and other tax laws through educational and compliance review activities.

For more information, visit our web site at www.irs.gov/govt/fslg. For account-related assistance, contact Customer Account Services at 1-877-829-5500. To locate an FSLG Specialist in your area, see the directory at the end of this newsletter.

The explanations and examples in this publication reflect the interpretation by the IRS of tax laws, regulations, and court decisions. The articles are intended for general guidance only, and are not intended to provide a specific legal determination with respect to a particular set of circumstances. You may contact the IRS for additional information. You may also want to consult a tax advisor to address your situation.

Federal, State and Local Governments

Paul Marmolejo, Director
Dwayne Jacobs, Manager, Compliance and Program Management (CPM)
Stewart Rouleau, Newsletter Editor (send comments and questions to Stewart.G.Rouleau@irs.gov)

Contents

[Sick Leave Payments for Accumulated Leave to Retiring Employees](#)
[IRS Office Issues Advice on Fee-Basis Officials](#)
[Government Entities Not Subject to FUTA](#)
[Assessing Internal Controls To Detect Risk of Fraud and Minimize Asset Thefts](#)
[2013 Revision of Publication 963 Available](#)
[Directory of FSLG Specialists](#)

PAYMENTS FOR ACCUMULATED LEAVE TO RETIRING EMPLOYEES

Employees of local governments often have substantial accumulations of sick and vacation pay at the time they retire. In many cases, contractual agreements between the employer and employee call for a lump-sum payment of all accumulated sick and vacation pay, as of the date of retirement. The payments often leave local governments and employees with large, unexpected tax liabilities. Many times, local governments and employees negotiate a payment plan to lessen the tax burden for both parties. Generally, the agreements are executed to defer the tax liability into other years. However, under the constructive receipt rules, the full amount is generally taxable when the employee has the option to receive the full amount. An employee cannot decide when the tax will be paid.

As we discussed in an article in our [previous newsletter](#), the constructive receipt rules under Internal Revenue Code section 451 require that individuals recognize income as soon as they have effective control over it; that is, when the funds are made available without substantial limitations. When an employee has an option to receive the income without restriction, it is recognized as income, regardless of whether the employee actually receives it at that time.

Example: City Government A owes Employee Z \$150,000 in accumulated sick and vacation pay as of the day of retirement. A month before Employee Z's retirement date, City A reaches an agreement to pay Employee Z \$50,000 a year for 3 years. City A intends to treat each of the 3 payments as wages and subject the payment to Federal Income tax withholding, social security, and Medicare taxes in each year. This arrangement does not defer the tax due. City A may choose to make the payments over the 3 years, but because the entire \$150,000 is available at retirement, it will be included in income, subject to income tax withholding and social security and Medicare taxes, as of the date the employee is entitled to the funds.

There are two key considerations to remember when considering payments of accumulated sick and vacation pay. First, does the worker have a right to receive the money? The worker does not have to exercise that right; the simple existence of the right to receive the money is sufficient to establish that a taxable event has occurred. Second, has the employee been given an option as to when to receive the funds? If the employee has an option, then the employee has constructively received the money. The right to receive the money or the option to receive the money determines whether the money has been constructively received. Once the money is deemed to have been constructively received, it is taxable at that point.

The tax treatment of distributions from various retirement plans varies, depending on the Internal Revenue Code sections applicable. For information about the types of plans and the rules applicable to them, see the IRS Employee Plans [Types of Retirement Plans](#) web page.

IRS OFFICE ISSUES ADVICE ON CONSTABLES AS FEE-BASIS OFFICIALS

On March 29, 2013, IRS Area Counsel issued Nondocketed Service Advice (NSA) (Memorandum 20131801F, available at <http://www.irs.gov/pub/irs-lafa/20131801F.pdf>) addressing the proper employment tax treatment of individuals in a position designated by a state as “constables.”

The term “constable” is applied to a specific government position in 21 states. The nature and responsibilities of this position may vary significantly from state to state, so you should not assume the analysis in this advisory is applicable to individuals called “constables” in another state. An NSA cannot be relied upon by taxpayers in other situations. However, the analysis in this advisory may offer insight into the how the Service would view similar positions in another situation.

In the situation considered, the constable position is an elective office. Incumbents perform such services as prisoner transport, service of summonses and warrants, court protection, and services relating to landlord/tenant disputes. The constables are required to take an oath of office and undergo a background check. They must also receive state-provided training and certification prior to performing services as a constable. Constables must provide proof to the clerk of courts that they hold professional liability insurance in amounts set by statute in order to maintain certification. Once constables are certified by the state, they have statewide authority and jurisdiction enabling them to perform services throughout the state, not just in the local area in which they were elected. Therefore, the constables may perform services for and receive payment from multiple counties. In some counties, constables serve as the primary means of law enforcement.

Five questions were addressed in this Nondocketed Service Advice:

- Are the elected constables covered under a section 218 Agreement?
- Are the constables considered fee-based public officials for self-employment tax purposes?
- Are the constables employees for FICA purposes?
- Are the constables employees for federal income tax withholding purposes?
- If the constables are employees, who is the employer?

The NSA addressed each of these questions as follows:

Are the elected constables covered under a section 218 Agreement?

A Section 218 Agreement (referring to Section 218 of the Social Security Act) may be made between the Social Security Administration (SSA) and the state to provide social security coverage for specific groups of employees within a state or a subdivision of a state. The SSA determines whether certain positions are covered by a Section 218

Agreement. In this case, the SSA determined that the Agreement did include the constable position.

Are the constables considered fee-based public officials for self-employment tax purposes?

Internal Revenue Code (IRC) section 1402(c) provides that public officials are not in a “trade or business” and therefore are not subject to self-employment tax (SECA). However, an exception is provided for a public official who is compensated solely by fees (referred to as a “fee-based public official”). If the position is compensated solely by fees, and the position is not covered by a Section 218 Agreement, the position is treated as self-employment and is subject to SECA.

The NSA established that, in this case, the constables collected amounts from the public, but were required to turn them over to the county. The county pays them an amount set by statute. For certain services, such as election work, they receive direct payments from the county. Therefore, the constables are not fee-based public officials and are not self-employed. (In addition, the constables are covered under the state 218 agreement. Coverage under a 218 agreement also removes the constables from the provisions of SECA.)

Are the constables employees for FICA purposes?

The definition of an employee for purposes of FICA includes “any individual who, under the usual common-law rules applicable in determining the employer-employee relationship, has the status of an employee” and “any individual who performs services that are included in an agreement entered into pursuant to section 218 of the Social Security Act.”

The common-law tests for determining who is an employee are discussed in detail in Publication 15-A and Publication 1779. In general, as stated in Treasury Regulation 31.3121(d)-1(c)(2), an employment relationship generally exists when “the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished. That is, an employee is subject to the will and control of the employer not only as to what shall be done but how it shall be done.”

In making this determination, the Service considers three primary categories of evidence – behavioral control, financial control, and relationship of the parties

The facts regarding behavioral control indicate that the constables are employees. The constables must undergo 80 hours of initial training plus up to 80 hours of additional training each year. These facts indicate that the state and/or the county have control over how the constables perform their duties.

The facts regarding financial control are mixed. Some facts indicate employee status, including the requirement that constables turn over all monies collected to the county and then only receive payment if they properly submit forms according to the county's procedures and a judge signs off on those forms. This indicates control over the finances at the county and state level. The constables are reimbursed for their mileage and are provided some tools (i.e., metal detectors and a desk). However, independent contractor status may be suggested because constables must provide some of the tools needed themselves. The constables also make an investment by posting a bond upon election. However, the constables have a minimized financial loss because in some cases they are able to collect payment regardless of whether they are successful in their services or not. While it is legally possible for constables to provide services for the public directly, for these workers it is rare.

The facts regarding the relationship of the parties are also mixed. The county had been treating the constables as independent contractors and reporting payments made to them on Forms 1099. In addition, the county does not provide any employee benefits to the constables. However, the constables have an ongoing relationship with the county as some of them have served for more than 20 years. In addition, the constables are completely integrated into the county business; the magisterial district court cannot function without them and the county relies on them to serve notices and execute warrants because they do not have enough police officers or sheriffs to do so. The constables can be terminated by a judge for failure to perform their duties pursuant to the statute.

As in most worker classification cases, the facts are not all indicative of an employee or an independent contractor. However, on balance, the NSA determined that the constables are employees. The state's ability to control how the constables perform their services through state statute, required training and the constable handbook is an especially strong factor that indicates they are employees subject to the control of an employer.

Are the constables employees for federal income tax withholding purposes?

IRC 3401(c) provides that, for purposes of income tax withholding, public officials are employees. Because the constables are elected officials of the county, they are employees for income tax withholding purposes.

If the constables are employees, who is the employer?

The constables primarily perform services for the courts, which are part of the state judiciary system. They also perform various election day services for the county, execute warrants, and impound livestock. They also perform services for private litigants, including carrying out ejectments in landlord-tenant disputes. However, the constables' payment for all of these services is controlled by the county, as the funds come from county checking accounts and the county verifies all submissions for

payments. Even if the county is not the common-law employer, the county is the employer for purposes of ITW and FICA because it controls the payments.

This analysis may be useful in determining the status of similar workers in other jurisdictions, especially where there is a question as to whether an individual is a fee-based public official. More information about these workers is available in section 5 and the Section 218 of the Appendix in [Publication 963](#). You may also contact an FSLG Specialist; a directory appears at the end of this publication.

GOVERNMENT ENTITIES NOT SUBJECT TO FUTA

Services rendered by employees of most states, political subdivisions or instrumentalities of the state are exempt from Federal unemployment (FUTA) tax. Therefore, public employers are generally not required to file Form 940, Employer's Annual Federal Unemployment (FUTA) Tax Return. Government entities that serve as fiscal agents are required to file Form 940 for home health workers; see [Notice 2003-70](#) for additional information and guidance. There are also some quasi-governmental entities that are required to file Forms 940.

FSLG has identified more than 1,500 government entities that are currently filing Forms 940 in error. If you are a government entity and have filed a Form 940 in the past, you should file a zero dollar, final Form 940 by checking Box "d" in the "Type of Return" box in the upper right of the form. If you are a government entity and paid FUTA tax in the past, you paid it in error.

Federal and state governments are established and recognized by the U.S. Constitution and state constitutions. Indian tribal governments are recognized by the U.S. Constitution, treaties, statutes and court decisions. Other entities may be recognized as governments by state law, court decision, or an examination of facts and circumstances that indicate it has the characteristics of a government, such as powers of taxation, law enforcement, and civil authority. If you are unsure about your government entity status please see the article on the FSLG website, "[Is My Entity a Government Entity?](#)"

Our web article discusses the different types of government entities and how the authority of each is established (state government, local government and subdivisions, Indian tribal governments, and instrumentalities). The defining characteristics of a government for tax purposes are also discussed in greater detail in [Publication 963](#), Federal-State Reference Guide.

If you still have a question about your status as a government entity, you may contact us for assistance using the [e-mail feature on our website](#). While we cannot make an official determination for you, we may be able to provide useful information. If you are certain that you are a government entity and you have erroneously filed Form 940 to pay FUTA Tax, see the current [Instructions for Form 940](#) for information about filing an amended return.

ASSESSING INTERNAL CONTROLS TO DETECT RISK OF FRAUD AND MINIMIZE ASSET THEFTS

Regarding conducting examination activities, the office of Federal, State and Local Governments (FSLG) and the Advisory Committee on Tax Exempt and Government Entities (ACT) are considering how to better address issues of fraud that may occur within state and local governments. Governments are susceptible to fraud committed by employees, contractors, and benefit recipients. Fraud involves any intentional or deliberate act to deprive another of property or money by guile, deception, or other unfair means. For example, employees can also skim receipts when collecting fees from the public. In addition, governments may be defrauded by citizens falsely claiming eligibility for certain benefits.

FSLG is currently assessing its strategy for addressing fraud as an examination issue with state and local governments. Since 2012, new guidance to field employees has been provided both through a “Fraud Job Aid” and additions to the Internal Revenue Manual. We plan to continue to seek ways to address this issue, so that we can leverage the internal controls of these entities to better identify fraud, work collaboratively with these entities on fraud issues, and ultimately improve tax administration.

There is considerable evidence that this is a significant problem for government entities. Every two years, the Association of Certified Fraud Examiners publishes a report to the nations. The latest such report is the “Report to the Nations on Occupational Fraud and Abuse 2012 Global Fraud Study,” available at www.acfe.com. Occupational fraud is defined as the use of one’s occupation for personal enrichment through the deliberate misuse or misapplication of the employing organization’s resources or assets.

Key findings included the following:

- The typical organization loses an estimated five percent of its revenues to fraud each year. The median loss caused by the occupational fraud cases was \$140,000. More than one-fifth of these cases caused losses of a least \$1 million.
- Asset misappropriation schemes were by far the most common type of occupational fraud, comprising 87 percent of the cases reported; they were also the least costly form of fraud, with a median loss of \$120,000. Financial statement fraud schemes made up just eight percent of the cases, but caused the greatest median loss at \$1 million.
- Occupational fraud is more likely to be detected by a tip than by any other method. The majority of tips reporting fraud come from employees of the victim organization.

The report also indicated that, in general, local governments are much more susceptible to fraud than states. In general, local governments are at a greater risk of experiencing

fraud than State governments. Generally, the larger the entity, the more likely it is to have internal controls to detect fraud.

ACT Fraud Subcommittee

The ACT is an advisory group of individuals with experience and expertise in topics related to the mission of TE/GE. The ACT/FSLG Subcommittee (Subcommittee) issued a report in August 2013 entitled “Federal State and Local Governments: Leveraging Internal Controls at State and Local Governments to Improve Compliance”. The report is intended to assess the impact of fraud in state and local governments, and to identify how the IRS can leverage internal controls at the state and local government level to better identify fraud, work collaboratively with these entities on fraud issues, and ultimately improve tax administration and compliance.

The report includes background on internal controls, fraud, waste, and abuse in governments, a survey of internal controls and specific recommendations. It also includes recommended updates to the FSLG Fraud Job Aid, a training outline for a possible webinar and other guidance on combating fraud to be offered by FSLG and National Association of State Auditors, Comptrollers and Treasurers to the state and local governments.

For this article, FSLG discussed the report with two of the Subcommittee members; Lisa Pusich, Deputy Director for the Department of Finance for the State of Alaska, and Kathy Sheppard, Deputy Commissioner for Finance for the State of Massachusetts.

Pusich stated that, “employee fraud most often involves asset misappropriation, including billing and skimming schemes.” For example, employees can bill shell companies or make personal purchases with fraudulent invoices.”

The report identifies three relatively low-cost areas where smaller units of government can take action to reduce fraud: (1) establishing a code of conduct; (2) training; and (3) management review of practices. Research indicates that these actions can significantly reduce the risk and extent of fraud. “Training should include both awareness of conduct that constitutes fraud, as well as how to detect it,” Pusich said.

Effective action against fraud is greatly aided by full participation by employees in the effort to combat fraud. “It is everyone’s job to report,” Sheppard said.

Pusich and Sheppard noted that there are many resources available to small units of government; some of these are noted below.

Recommendations

The Subcommittee report made several recommendations for FSLG, including the following:

Determine the Extent of Internal Controls – FSLG issued a “Fraud Job Aid” and guidance in May 2012 to provide guidance to Field Specialists to identify potential

fraudulent activities and to develop fraud referrals as necessary. The IRS could identify the extent of internal controls at the entities to be audited and adjust its audit scope accordingly. The IRS should consider using The Fraud Job Aid for entities with little or no internal controls and conduct more fieldwork on fraud for these entities. For entities with strong internal controls, the IRS should consider relying on these internal controls and reduce the fraud detection scope of the audit.

Size of Entity – The IRS could consider additional procedures regarding fraud for smaller entities, which typically have fewer internal controls and greater incidence of fraud than larger entities. The Fraud Job Aid could be modified to reflect the adjustments that might be made based on the size of the entity.

Develop and conduct training on internal control and fraud – The subcommittee believes that an IRS webinar could identify the benefits of conducting a risk assessment in performing audits. In addition, the webinar could highlight relatively inexpensive steps smaller organizations can take to protect against fraud. In addition, FSLG can reach out to national associations, such as the National Association of State Auditors, Comptrollers, and Treasurers (NASACT) and the Government Finance Officers Association (GFOA) to offer joint training on internal control and fraud.

FSLG will consider these recommendations as it pursues ways to improve fraud detection and assist governments in improving their controls against fraud.

Resources for Governments

There are a variety of resources available to state agencies local governments providing information on training and detection of fraud:

- Check <http://www.irs.gov/govt/fslg> frequently for information on webinars and other upcoming educational events. This site also other related publications, fact sheets and tools that may be of assistance.
- You may access the comprehensive, biannual report of the Association of Certified Fraud Examiners, cited above, at www.acfe.org.
- The websites for the following governmental associations, mentioned above, may also be helpful:
 - NASACT (www.nasact.org).
 - GFOA (www.gfoa.org)
- Check with the finance department of your state governments to determine what resources may be available to governmental units in the state.
- Consider subscribing to the free information site “Fraud of the Day” (www.fraudoftheday.com), a service of several organizations dedicated to educating government about how fraud is perpetrated and the solutions to stop it.

- You may contact a local FSLG Specialist with questions you have about FSLG procedures to address fraud in examination, and any other Federal tax questions of interest to governmental entities. A directory of Specialists follows below.

2013 REVISION OF PUBLICATION 963 AVAILABLE

The IRS has released a November, 2013, revision of Publication 963, Federal-State Reference Guide. This publication was created in 1996 as a cooperative effort of the IRS, the Social Security Administration, and the National Conference of State Social Security Administrators, to address social security coverage and Federal tax issues for government entities, especially units of local governments dealing with Section 218 voluntary coverage agreements. This publication also addresses general employment tax, fringe benefit, information reporting, and other common tax issues, specifically with governmental entities in mind.

Publication 963 is not currently available in print; however it can be accessed and downloaded from the FSLG web page at [Educational Resources page](#). It is also available from the IRS [Forms and Publications Catalog](#).

DIRECTORY OF FSLG SPECIALISTS

Alabama	Deishun Garmon-Robinson	(251) 341-5921
	John Givens	(251) 341-5993
Alaska	Gary Petersen	(775) 325-9721
Arizona	Wayne Woods	(602) 636-9124
Arkansas	Jan Germany	(501) 396-5816
California	Ronald Coleman	(619) 744-7169
	Jay Gonzales	(619) 744-7160
	Alice Huang	(626) 927-1238
	Thomas Mansell	(707) 535-3830
	Nimfa Pegram	(619) 744-7161
Colorado	Chuck Sandoval	(720) 956-4407
Connecticut	Mary Rogers	(508) 559-4584
Delaware	Hilton Finney	(215) 861-3732
	Veronica Green Bell	(215) 861-1562
District of Columbia	James Driver	(859) 244-2449
Florida	Fernando Echevarria	(954) 423-7406
	Michael Moore	(561)-616-2092
Georgia	Wally Reimold	(615) 250-6051
Hawaii	Clark Fletcher	(425) 489-4042
Idaho	Chris Casteel	(208) 363-8818
Illinois	Paula Graham	(618) 242-5603
Indiana	Raelane Hoff	(812) 231-6502
Iowa	Ryan Johnson	(402) 233-7412
Kansas	Allison Jones	(316) 651-2193
	Dena Jones	(816) 966-2346

Kentucky	Talaka Whitlock Crystal Fitzgerald-Evans	(502) 420-1586 (502) 420-1597	
Louisiana	Claire Bullock Lynette Thibodaux	(318) 683-6311 (504) 558-3144	
Maine	John Hart	(603) 433-0732	
Maryland	James Driver Hilton Finney	(859) 244-2449 (215) 861-3732	
Massachusetts	John Hart Mary Rogers	(603) 433-0732 (508) 559-4584	
Michigan	Lori Hill	(906) 228-7831	
Minnesota	Steven Haupt Lori Stieber	(651) 726-1488 (651) 726-1421	
Mississippi	John Givens	(251) 341-5993	
Missouri	Sharon Boone Dena Jones	(417) 891-1458 (816) 966-2346	
Montana	Bruce Gilbert	(307) 672-7425	x43
Nebraska	Ryan W Johnson	(402) 233-7412	
Nevada	Gary Petersen	(775) 325-9721	
New Hampshire	John Hart	(603) 433-0732	
New Jersey	Pat Regetz Vincent Urciuoli	(908) 301-2119 (908) 301-2660	
New Mexico	Carl Chavez Bob Ching Toni Holcomb	(505) 837-5610 (505) 424-5984 (505) 527-6900	x232
New York	Dave Coulon Jean Redman Granville Shannon	(315) 233-7305 (607) 734-1063 (212) 436-1492	x108
North Carolina	Jammie Owens	(336) 574-6161	
North Dakota	Rhonda Kingsley	(701) 237-8324	

Ohio	John Darr Wendy Speelman	(419) 526-2886 (419) 526-2607	
Oklahoma	Brenda Hollingsworth	(405) 297-4959	
Oregon	Clark Fletcher	(425) 489-4042	
Pennsylvania	Hilton Finney Veronica Green Bell	(215) 861-3732 (215) 861-1562	
Puerto Rico	Fernando Echevarria	(954) 423-7406	
Rhode Island	Mary Rogers	(508) 559-4584	
South Carolina	Clifford Brown	(803) 253-3523	
South Dakota	Rhonda Kingsley	(701) 237-8324	
Tennessee	Wally Reimold	(615) 250-6051	
Texas	Robert Jackson Steve O'Brien Michelle Pringle Todd Weidner	(281) 721-7993 (512) 339-5508 (214) 413-5448 (512) 499-5285	
Utah	Chris Casteel	(208) 363-8818	
US Virgin Islands	Clifford Brown	(803) 253-3523	
Vermont	Stephen Polak	(802) 859-1049	
Virginia	Patsy Kerns	(304) 561-3010	
Washington	Clark Fletcher	(425) 489-4042	
West Virginia	James Driver Patsy Kerns	(859) 244-2449 (304) 561-3010	
Wisconsin	David Rasmussen	(262) 513-3424	
Wyoming	Bruce Gilbert	(307) 672-7425	x 43